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SUBJECT: KAZAKHSTAN - GOVERNMENT MOVING FORWARD ON TAX CODE REFORM

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Summary

1. Following presidential guidance, a Government of Kazakhstan (GOK) Tax Working Group quickly produced proposed amendments to the tax code. USAID assistance in the areas of corporate income tax, value added tax (VAT) and the attendant administrative procedures was well received. On June 18, Prime Minister Masimov chaired a round table presentation and discussion of the concepts included in draft tax code amendments. The stated goals in drafting were that the tax code should comply with the principles of clarity, equity, transparency, and coherence and that the amendments should incorporate international best practice to support voluntary compliance, including in registration, assessment and payment of taxes. In general, the proposals clearly move toward those goals. While specific rates were not mentioned, it is likely that the rates for corporate income tax will be significantly reduced. End Summary.

Tax Code Reform: A Government of Kazakhstan Priority

2. In his annual address to the nation on February 6, President Nazabayev made reform of the tax code a priority task for this year. In particular, he said: "The current tax code has played a positive role in economic growth; however, its potential is practically exhausted. The code includes over 170 privileges and preferences, which are constantly and unsystematically increasing. The government shall elaborate a new tax code. It shall facilitate modernization and diversification of the economy, withdrawal of businesses from the 'shadows,' as well as combine administration with the interests of tax-payers. But most importantly, it shall envisage reduction of the total tax burden for non-primary economic sectors, particularly for small and medium sized-businesses. The estimated budget losses shall be compensated by increased economic returns from the extractive sector."

3. On February 8, Prime Minister Masimov issued an order putting Deputy Prime Minister Orynbayev in charge of a 25-member, multi-agency Working Group ("the WG") led by the Ministry of Economy and Budget Planning (MEBP) and including all relevant ministries and agencies as well select representatives of the business sector to develop and submit the draft tax code for government consideration by July 1, 2008. Organizing the WG process was completed by early April, when drafting began in earnest. Given the short time frame the focus was on substantial amendments (as opposed to a new code) to the code which would bring it in line with the President's objectives of improving the efficiency and effectiveness of the system.

4. In early April, the WG presented a specific list of issues on which international expert assistance was requested, including a number of well-defined points of procedure and principles related to corporate income tax, taxation of the financial sector, and value added tax (VAT), with particular reference to improving VAT refunds. Additional issues included enhanced self-assessment, sector specific issues for transport, real estate, agriculture, and support

for small and medium enterprises (SMEs); and proposals to streamline and improve tax administration. Following donor coordination discussions, a focused program of USAID technical assistance was agreed to in the areas of corporate income tax, VAT, and related changes for tax administration.

USG Support: U.S.-Kazakhstan Program for Economic Development

15. USAID collaboration with the Government of Kazakhstan (GOK) in the area of economic development is currently organized under the jointly-funded Program for Economic Development (PED). In 2008, USAID is implementing nine projects under the PED including the "Economic Reform to Enhance Competitiveness" (EREC) Project, which has within its scope of work specific tasks to build capacity with MEBP in a variety of areas related to fiscal policy development and implementation. In early March, USAID representatives and a technical team from the EREC Project met with MEBP to discuss the full range of EREC implementation issues within the frame of the PED. At that meeting, MEBP gave strong direction to prioritize USAID assistance via EREC on the tax code.

16. Given the accelerated time-line for preparing the new tax code, the EREC team operated in "drafting mode", focused on providing targeted, substantive reviews of proposed draft text for amendments to the tax code, as requested. Associated brief policy reviews incorporated a comparison to a range of international best practices, analysis of amendment effectiveness in achieving goals, and any possible recommendations for improvement designed to maximize effectiveness of assistance by ensuring that discussion targeted the identified needs of the Working Group.

The Current Situation

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17. On June 18, Prime Minister Masimov chaired a round table presentation and discussion of the draft tax code in Astana, which included the full range of GOK ministries and agencies, representatives of the Mazhilis and Senate, representatives of the business sector, and donors. Deputy Prime Minister Orynbayev made the lead presentation which focused on a summary of key changes under a number of headings, including implementation of the "directly applicable law" principle; corporate income tax; VAT; reform of small businesses taxation; reform of agriculture taxation; property tax for legal entities and individual entrepreneurs; social tax; optimization of tax concessions; reform of international taxation; reform of mineral resources users' taxation; and tax administration. The stated goals in drafting were that the tax code should comply with the principles of clarity, equity, transparency, and coherence and that it should incorporate international best practice to support voluntary compliance, including in registration, assessment and payment of taxes. In general the proposals clearly move toward those goals.

18. With regard to the corporate income tax, the key changes are to: adapt the tax code to the application of International Financial Reporting Standards (IFRS); cancel advance payments for corporate income taxes for SMEs; and increase the period for tax loss carry-forward to 10 years from the current 3 years. With regard to the VAT, the key changes are: a well-defined and phased approach to streamlining and speeding up refunds through the introduction of a risk assessment system for targeting audits; and a phased elimination of deferrals for imports of machinery and equipment not produced in Kazakhstan (by 2011) and of intermediate goods for industrial production not produced in Kazakhstan (by 2012). With regard to tax administration, the key changes are to: increase the length of time for submission of tax returns while establishing a uniform period both for filing and payment; introduce a system of risk management for audit that meets international standards for clarity and transparency; and increase the automation of tax administration processes.

19. With regard to proposed changes for the reform of small business and agricultural taxation, of property tax for legal entities and

individual entrepreneurs of social tax; and for the elimination of tax concessions and reform of international and mineral resources taxation, the proposals are broadly in line with the directions of tax policy recommendations developed since 2006 in collaboration with the World Bank under the Joint Economic Research Program (Tax Strategy Paper: Volume I "A Strategic Plan for Increasing the Neutrality of the Tax System in Non-Extractive Sectors; Volume II: Tax Administration Issues).

¶10. With regard to changes in taxation of mineral resource users, the proposed changes include replacement of royalty with a tax on mining operations (TMO) that shall be paid for each type of mineral resources produced in Kazakhstan. The volume of hydrocarbons and the solid mineral resources (SMR) contained in the ore (concentrate, solution) will be taxed. Rates shall be established following the decision on how much the corporate income tax will be in the new tax code provided that the change in the total tax burden ensures acceptable profitability for mineral resources users (no less than 10%); TMO rates for oil, including gas condensate shall be established as per ascending scale with consideration of the volume (recoverable reserves, production) based on the world price. For low-profitable, high-viscosity, watered, low-yield and worked-out deposits there shall be established decreasing coefficients to the TMO rates. For natural gas, including gas hydrocarbons, extracted together with the liquid hydrocarbons, the rate would be 15%.

¶11. In the area of international taxation: the concept of "constructive dividends" (the amounts paid by a company to the shareholder, founder, participant or its interrelated parties for goods, works or services which violate the "arm's length" principle) will be introduced and tax agents will be allowed to independently apply the provisions of international agreements and take decisions on release from the tax or refusal at the moment of income payment to a non-resident, on the basis of the residency certificate.

Opportunities and Risks

¶12. The proposed changes to the tax code to be considered by the GOK in July are generally quite positive, although it remains to be seen whether they will be substantially revised during the period of government review. While the government has yet to propose tax rates, it is likely that corporate income tax will be reduced from 30% to 15%, that social tax will be changed from a regressive 5-20% tax to a flat 10%, and that there will be a declining VAT. Current simplified regimes for SMEs, contrary to USAID advice, would remain.

¶13. In Kazakhstan, as throughout Central Asia and the former Soviet Union, there is often a significant gap between law and its implementation. The current tax code is often not implemented according to its spirit, much less its letter, and there remain significant implementation risks with the new code.

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¶14. Representatives of Kazakhstan's business community have expressed their concern about not being involved in process of elaborating the amendments. Their proposals notably include VAT exemption for businesses that provide services, granting 5-year tax exemptions to manufacturing businesses, reduction of the corporate income tax to 10%, and reduction of social tax to 5% or replacement of social tax with compulsory medical insurance.

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